TJT CAPITAL GROUP

On Our Radar – June 2018

Volatility continued to run high during the month of May as the outlook for trade policy caused uncertainty to rise as initially proposed tariffs were on, then off, then on again with several of our large trading partners. The Trump administration said it would impose tariffs of 25 percent on steel and 10 percent on aluminum coming into the U.S. from Canada, Mexico and the European Union.

President Trump said “the U.S. has been taken advantage of for many decades on trade. Those days are over.” He further stated that the “U.S. will agree to a fair deal, or there will be no deal at all.” Now that President Trump has fired the first shot, countries on the receiving end of those tariffs are threatening to respond in-kind by slapping tariffs on U.S. products.

Moreover, the White House has threatened to impose tariffs on up to $50 billion of products from China. In mid-May, however, U.S. Treasury Secretary Steven Mnuchin said the proposed tariffs were put on hold pending ongoing negotiations and China’s pledge to increase purchases of U.S. goods in an effort to reduce the nearly $340 billion trade deficit. In response to a more recent threat, China said “if the U.S. introduces trade sanctions including a tariff increase, all the economic and trade achievements negotiated by the two parties will not take effect.”

Despite that, the S&P 500 Index rallied over 2 percent in May and is up about 1.1 percent, excluding dividends, for 2018.

TJT Capital Group relies on our InVEST Risk Model to help determine whether we have bull market or bear market conditions with a goal of participating in bull markets and protecting capital in bear markets. The following is an update on the 5 indicators that really matter.

Interest Rates (Monetary Policy)

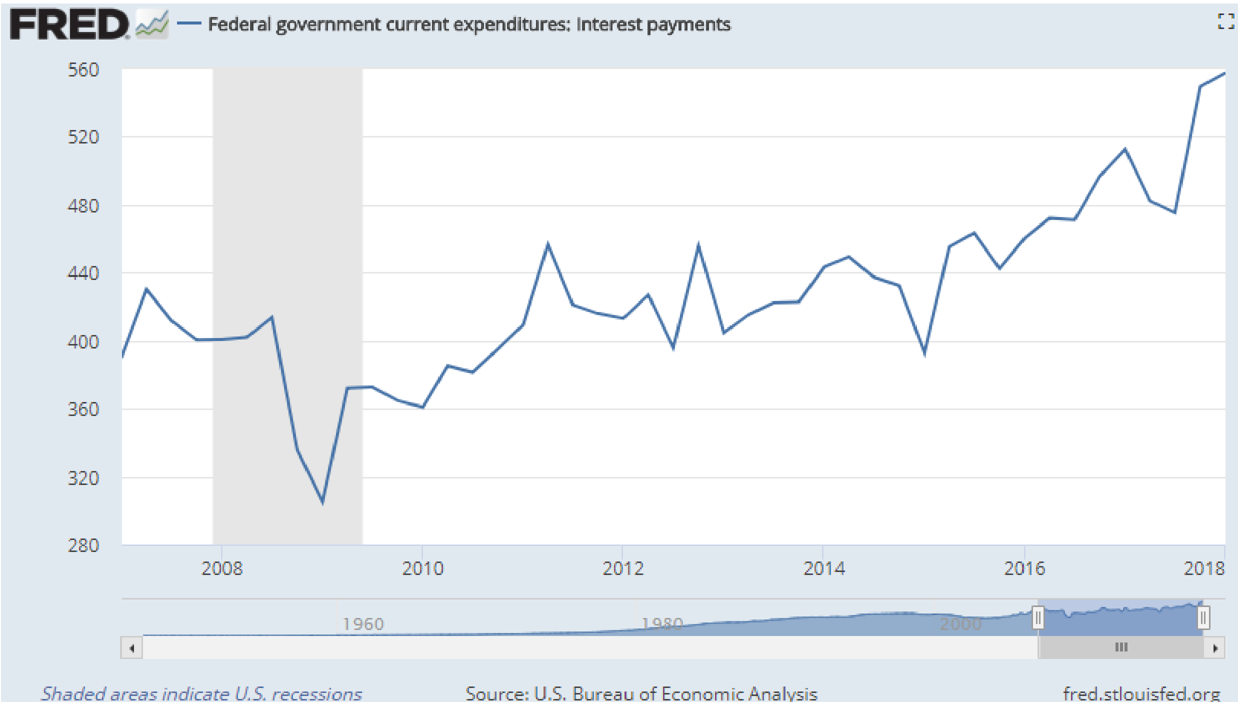
Interest rates have been moving higher. In fact, the 6-month U.S. Treasury Bill (2.08%) was paying more at the end of May than the 10-year U.S. Treasury Note yielded back in September 2017 (2.05%).

The Federal Open Market Committee (FOMC) will likely increase the federal funds rate at their upcoming meetings on June 12-13, 2018. The minutes released from their early May meeting indicated that “conditions would evolve in a manner that would warrant further gradual increases in the federal funds rate,” and that “it would likely soon be appropriate for the Committee to take another step in removing policy accommodation.”

The Federal Reserve’s quantitative easing (“QE”) asset purchase program has had an enormous impact on asset prices around the globe. Despite the fact that U.S. debt has more than doubled since the financial crisis, the manipulation of lowering interest rates by purchasing trillions of dollars of bonds caused interest payments by the U.S. government to remain roughly flat for almost a decade.

However, with interest rates rising across the board, the trajectory of those interest payments has begun to rise as seen in the chart on the following page. Moreover, the federal government is on track to borrow nearly $1 trillion this year, almost double the amount from a year ago, in order to fund the deficit. Nevertheless, the Fed is trying to engineer a gradual removal of monetary accommodation without causing a shock to the economy or the markets.

Historically, an inverted yield curve, whereby short-term interest rates are higher than longer-term interest rates, has indicated an increased risk of recession. Atlanta Federal Reserve Bank President Raphael Bostic recently said we are aware of the risks, “so it is my job to make sure that doesn’t happen.”



Valuation

S&P 500 consensus operating earnings estimates for 2018 are roughly $157, putting the forward price/earnings ratio on the S&P 500 index at about 17- times earnings. Much of the recent increase in earnings can be attributed to the corporate tax cuts, a rebound in oil prices, and a lower U.S. dollar.

As the calendar approaches the second half of the year, the market usually begins to focus on the 2019 estimates, which are currently north of $170 for the S&P 500. As such, we consider valuation to be in fair territory.

Economic Cycle

The U.S. economy grew at a revised 2.2 percent in the second quarter, down from the previous estimate of 2.3 percent. The Institute for Supply Management (ISM) Manufacturing index was 58.7 percent in May, up from April's reading of 57.3 percent, the Leading Economic Index has increased in each of the last three months, and retail sales rose 4.7 percent year-over-year.

Oil prices, on the other hand, have increased more than 50 percent over the past twelve months. At some point higher interest rates and higher oil prices could begin to restrict economic growth.

Sentiment

Bullish investor sentiment has been on the rise following the first ten percent decline since 2016. January saw bullish levels of over 66 percent, which rivaled those seen at previous market peaks. That level of euphoria was quickly corrected in lock-step with the February – May decline in the markets. Nevertheless, the number of bullish advisors in the Investor Intelligence survey has risen from a low of approximately 42 percent in April to near-50 percent at month-end.

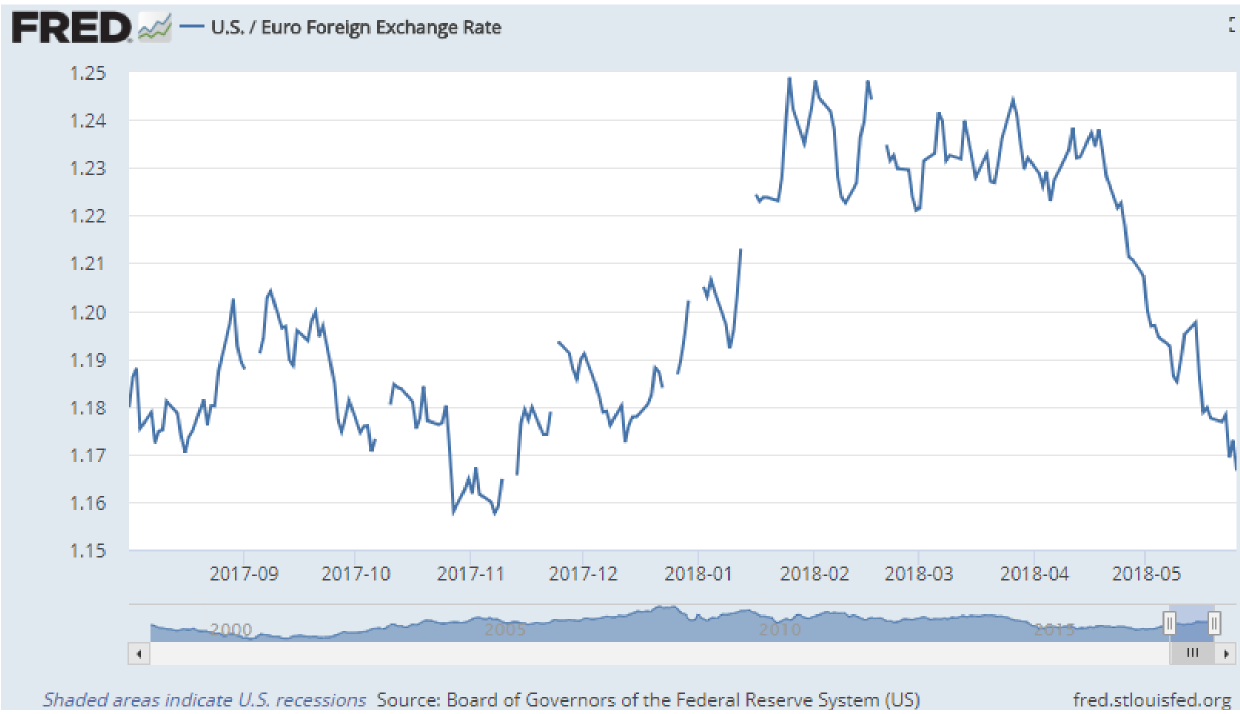
Technical Factors

A majority of technical indicators are mixed, consistent with the recent choppy trading. The Dow Theory's last signal was bearish as both the Dow Jones Industrial Average and Dow Jones Transportation Average broke below a previous low, however, the market has not followed through to the downside.

Outlook

The implications of a rise in political instability in some European countries caused a bout of weakness and volatility in global markets due to elections in Italy and Spain. Interest rates on 10-year Italian government bonds, for example, rose from 1.75 percent to about 3.16 percent in a matter of weeks on concerns about Italy's intentions to stay in the European Union.

In addition to the political implications, the Eurozone Purchasing Managers Index hit an 18 month low, which has caused the euro to fall from roughly 1.24 to the U.S. dollar to about 1.16 recently as seen below.



Uncertainty over trade policy and elevated trade tensions, rising political instability, and the Federal Reserve tapping on the brakes have caused volatile swings in stocks, bonds, commodities and currencies. Higher debt levels across the board make economies more sensitive to higher interest rates, and interest rate spikes due to political uncertainty can have ripple effects across markets.

The U.S. markets have been in a correction of sorts as prices adjust to these headwinds. That said, our assessment of the major components (of our risk model – of risk) are, on balance, still constructive. The Federal Reserve's monetary policy is still accommodative, although conditions have clearly tightened over the past eight months.

The Fed's prior two tightening cycles, including 2004-2006, coincided with double-digit gains in the broad index.

The U.S. economy continues to grow, and the traditional warning signs of an imminent slowdown seen in the unemployment rate, industrial production, and Leading Economic Index are not present. We view the market to be in fair-value territory with S&P 500 operating earnings estimated to be roughly $157. Bullish sentiment, however, is still high, which we consider a contrary indicator, and the market technical factors are mixed.

Should an actual trade war escalate, it would obviously have major implications for the financial markets. As we have seen, one "tweet" has the ability to change sentiment quickly. For example, on May 13th President Trump tweeted "President Xi of China and I are working together to give massive Chinese phone company, ZTE, a way to get back into business, fast." Later in the month he tweeted "Our Trade Deal with China is moving along nicely." Now both countries weigh the next steps in negotiations.

A more level playing field on trade would likely be welcomed by many U.S. companies; higher import prices due to tariffs would not.

If what you have been doing has not been as effective as it could be, do not hesitate to give us a call. (6.4.18)

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